# LUTHER KING CAPITAL MANAGEMENT

## *SECOND QUARTER 2019 REVIEW*

The economy has grown for 121 consecutive months, marking the longest economic expansion in American history. Since June 2009 the economy has grown without a recession and now surpasses the previous record expansion set between March 1991 and March 2001 that ended with the bursting of the dot-com bubble. The current decade-long expansion has been fueled by job growth, steadily lower unemployment, and very low interest rates. This cycle, however, also has the distinction of being the weakest expansion of the eleven post-war economic cycles. The slow and steady growth has helped mitigate the historically more frequent boom-bust economic pattern.

Global growth is showing additional signs of slowing. While still positive, the more uneven pattern of growth has caused central bankers to adopt a more dovish posture. The tightening bias the Federal Reserve had at the beginning of the year has shifted to an inclination to ease monetary policy. Recessions are generally brought about when imbalances in the economy emerge and are met with rising interest rates. We do not yet see any overly-concerning imbalances in the domestic real economy or capital market, with the exception of debt levels in certain circumstances. Further, the Federal Reserve's recent signaling that it is likely to cut interest rates should pull forward consumption and, therefore, extend the current record expansion.

The unexpected pivot by the Federal Reserve has been enthusiastically met in the financial markets, which have now fully recovered from the fourth quarter weakness. Equity prices, as measured by the Standard & Poor's 500 Index, rose 18.5% during the first half of the year. The Dow Jones Industrial Average Index advanced 7.3% in June, its best June since 1938. At the same time, the yield on the 10-year Treasury note closed the second quarter at 2.01% down from a seven-year high of 3.24% in November of last year.

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## *ECONOMY*

The primary storyline for the first half of the year has been the abrupt change in the expected path of interest rates.  In December, the Federal Reserve was suggesting that the lack of inflationary pressure within the economy was only transitory, and it stood ready to raise interest rates in order to battle higher inflation.  In fact, 15 of the 17 participants at the December 2018 Federal Reserve meeting expected interest rates to rise by 0.50% in 2019.  By March, the guidance for interest rates had fallen to none and the market expectations today call for at least a 0.50% reduction in interest rates.  The expectation of an immediate reduction in interest rates stands in stark contrast to an annualized economic growth rate of 3.1% in the first quarter before inflation and an unemployment rate that is the lowest rate since 1969.  The Federal Reserve appears to be responding to two very closely related developments, the multi-front trade war and the collapse of inflation expectations, often a harbinger of a general decline in global economic growth.

The administration is in various stages of considering and implementing trade tariffs on select goods from China, Canada, Mexico, India, and the European Union.  The Chinese trade negotiations have rightly received a great deal of attention, and investors cannot accurately handicap the three most likely outcomes of the talks.  One possible outcome is that both sides concede that a trade war is not winnable and ultimately reach an accord that includes modest concessions.  This scenario remains our base case, although we believe the administration is likely to wait until the Federal Reserve cuts interest rates before declaring victory on trade.  Second, it is possible that the trade war truce is sustained and an additional 25% tariff on Chinese imports is not implemented.  Finally, the trade war could escalate and intensify its drag on domestic economic growth.

The greatest near-term peril for the economy is the escalation of trade barriers and the resulting impact on global corporate supply chains.  This dynamic, given enough momentum, could bring about a negative supply shock to the economy which differs from previous economic downturns.  Severe recessions most often accompany the unwinding of speculative excess that was financed by too much debt and caused either price inflation or asset inflation, or both, to soar.  Such episodes result in a prolonged hangover for the real economy, as the unnecessary investment activity which created the economic boom and excess capacity ceases.

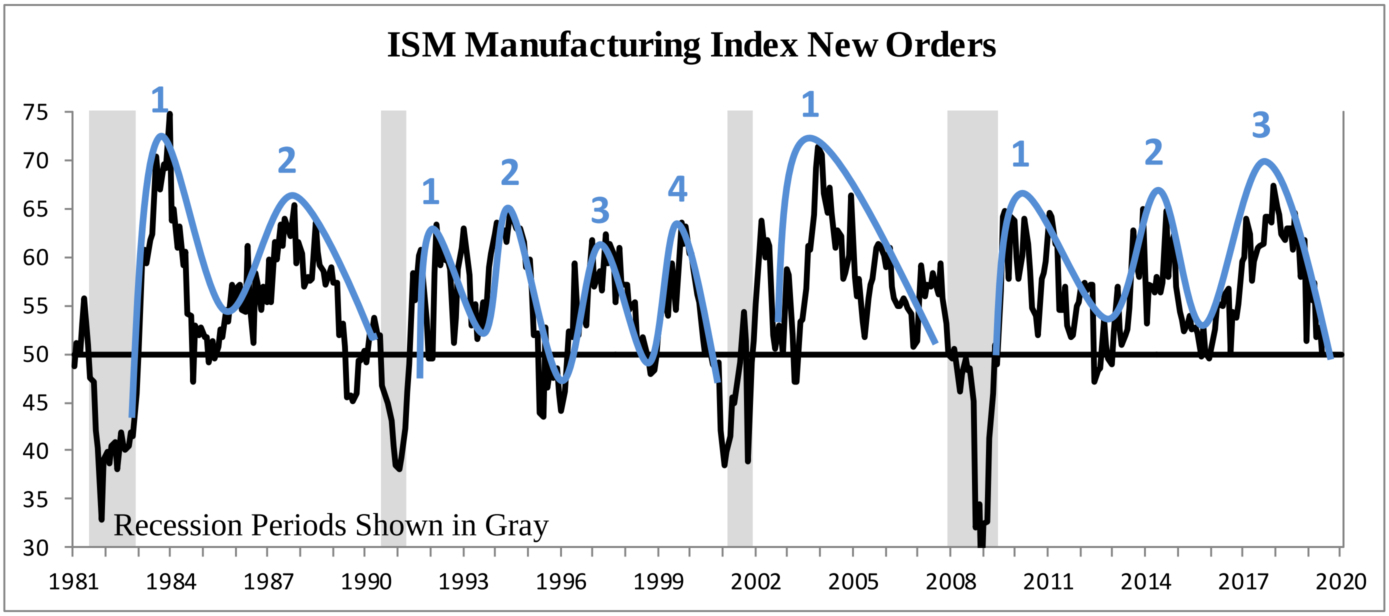
The housing bubble in the mid-2000's and the technology bubble in the late 1990's are both examples of excessive investment. Workers that were employed in areas of the economy in which the overinvestment took place were laid off, acting as a drag on consumer confidence and consumption. The result is low interest rates and inflation for years, high unemployment, and slower economic growth.

A large supply shock to the economy differs from an excessive investment boom because it does not result in an investment overhang. For example, if trade with a particular country was sharply curtailed due to higher tariffs, companies would adapt over time by relocating their supply chains. Consumers would most likely have to cope with higher prices and product shortages near-term which would negatively impact economic growth through lower consumption and would ultimately be deflationary for the economy. However, the economy would not experience the long-term detrimental drag on output that results from significant overinvestment and subsequent asset bubble burst.

## *CAPITAL MARKETS*

Domestic bond yields fell in the first half of the year despite rising equity prices which continued to make new highs. The equity market appears optimistic about the future of this record economic expansion, whereas the bond market is acting increasingly nervous. The general order of capital markets is for equity prices to rise when the economy is strong or showing signs of improvement following a recession. That is partially because corporate profits are increasing, which leads to higher stock prices. However, strong economic growth can eventually bring about inflationary pressures. In response to concerns over rising inflation, bond investors demand higher interest rates to compensate them for the corrosive effect of rising inflation which pushes down bond prices. From a macro viewpoint, it is important for investors to monitor when stock and bond prices are moving in the same direction. This trend can often be a leading indicator that an economic inflection point may be on the horizon.

The historically unusual pattern of rising equity and bond prices (falling bond yields) has occurred several times in the current bull market heralding the approach of an economic turndown. Yet in each case, there was simply a temporary economic slowdown within a continued economic expansion. Indeed, market cycles are much more frequent than economic cycles. This gives rise to one of the key distinctions between "Main Street" and "Wall Street". Main Street is descriptive of the real economy in which consumer consumption represents roughly two-thirds of the economy, thereby diluting the historically most volatile component of the U.S. economy: manufacturing. The equity market, or "Wall Street", in contrast has a much higher manufacturing component in the form of manufacturing-related corporate earnings. The following chart depicts U.S. manufacturing activity employing the ISM Manufacturing New Orders Index within the context of economic cycles with recessionary periods indicated as vertical gray bars. As the chart illustrates, manufacturing activity is currently experiencing its third slowdown within the current economic expansion.




Source: Institute for Supply Management, CSM, LKCM

An alternative explanation to recession fears alone causing falling bond yields is that the bond market is simply reacting to lower inflation expectations. The University of Michigan consumer survey in May showed consumers expect annual inflation to average 2.6% over the next five years. Those expectations fell to 2.2% in the most recent survey, which is the lowest level in the 40 years the question has been included in the survey. Bond yields typically fall in response to softer inflation data because rising consumer prices undermine bonds, chipping away at the purchasing power of fixed payments. Recent declines in inflation expectations have also increased the likelihood that the Federal Reserve will lower its target interest rate. There is not a crisp and satisfying answer for why inflation readings have remained persistently low during the current decade-long economic expansion. The conditions that have historically brought about inflationary pressures are generally thought to be in place, such as a growing economy and a very tight labor market. Investor psychology may be part of the root of low inflation expectations. Investors are increasingly conditioned to the notion that every crisis will send bond yields lower: e.g., the sub-prime mortgage crisis and the European debt crisis.

Now, we have the trade war crisis. If history is a guide, Treasury yields may continue their current slide as it is rare for them to bottom before the first Federal Funds rate cut.

We forecast overall corporate profits will grow 3-5% for the year. The Information Technology, Materials, and Energy sectors, which cumulatively represent 29% of the Standard & Poor's 500 Index, will likely each earn less this year than last. Earnings of semiconductor chip-related companies are being negatively influenced by trade tariffs resulting in negative earnings growth for the group on a year-over-year basis in 2019. Companies in the Energy sector are being negatively impacted by lower average commodity prices this year compared to 2018. Finally, the Materials sector has been adversely impacted by lower global economic growth as well as unfavorable agriculture conditions.

## *CONCLUSION*

Over the past month, downside risks to the outlook for the U.S. economy have been building. Many investors and business managers had anticipated a quicker resolution to trade issues than has materialized. We are already seeing evidence of the trade war in recent economic data. Global manufacturing was the weakest since 2012 in May, global export orders contracted for a ninth month, and China's economy lost momentum in April and May. One measure of overall global economic health, The Global Economic Surprise Index, has been negative for 14 months, a streak unseen in the index's 16-year history.

The deteriorating economic readings and falling inflation expectations have compelled the U.S. and European central banks to put capital markets on notice that they are now biased towards easing monetary policy to sustain the economic expansion. In one sense, the Federal Reserve appears ready to cut interest rates in response to low bond yields and market participants are pushing down bond yields in anticipation of easier monetary policy. While the list of concerns remains quite long and includes creating trade policy by tweet, BREXIT, and Iranian relations, our base case forecast is that the economic expansion remains intact near-term, albeit at a slower pace.

## *FINANCIAL MARKET TOTAL RETURN**

| | Second Quarter 2019 | Six Months Ending 06/30/19 | One Year Ending 06/30/19 | Annualized Return Two Years Ending 06/30/19 | Annualized Return Three Years Ending 06/30/19 | Annualized Return Five Years Ending 06/30/19 |
|---|---|---|---|---|---|---|
| Standard & Poor's 500 Index | 4.30% | 18.54% | 10.42% | 12.38% | 14.19% | 10.71% |
| Russell 2000 Index | 2.10% | 16.98% | (3.31%) | 6.62% | 12.30% | 7.06% |
| Value Line Composite Index | 0.55% | 14.01% | (4.47%) | 3.05% | 7.25% | 3.15% |
| Dow Jones Industrial Average | 3.21% | 15.40% | 12.20% | 14.23% | 16.80% | 12.29% |
| NASDAQ (OTC) Composite | 3.88% | 21.34% | 7.81% | 15.50% | 19.66% | 14.07% |
| Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index | 2.59% | 4.97% | 6.93% | 3.11% | 1.99% | 2.39% |

** Total Return Includes Income*

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## IMPORTANT INFORMATION

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